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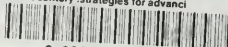
***The Next
Century:
Strategies
for
Advancing
Montana's
Economy.***

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December 1988

The Honorable Ted Schwinden
State Capitol
Helena, Montana

Dear Governor Schwinden:

Montana approaches the beginning of its next century of statehood with a mixture of hope and concern. After a century of living in an economy often dominated by forces beyond its control, Montana now is taking charge of its own economic destiny.

Today's challenge—to ensure that the next century provides more constant economic opportunity than the first—requires the coordinated effort and support of all Montanans. It will not be easy. In a period of fiscal constraint, little public money exists to finance investments to help build a stable economy that will provide jobs and income for the future.

This document aims to do two things in response to your charge of a year ago: first, to present a concise and accurate portrait of Montana's economy—where we are, how we got here, and where we are going; and second, to outline broad public strategies through which state and local governments can nurture private economic development.

Research for *The Next Century* was conducted under the overall management and assistance of the Montana Department of Commerce. The project benefitted greatly from the expertise of nationally recognized economic development specialists Roger Vaughan and William Nothdurft, who developed a framework for analysis of the Montana economy and provided observations regarding the role of state government in the business of economic development in Montana. Valuable information and suggestions were provided throughout the project by individuals representing state and local government agencies and private sector organizations.

The document consciously does not list actions to strengthen specific economic sectors. We chose, instead, to focus on what local and state governments can do to strengthen all sectors of the economy.

We had another purpose as well. In response to your request that our recommendations “. . . allow Montanans to make the most of today's and tomorrow's opportunities,” we designed this document as a framework for debate about the state's economic future—a factual base from which solutions may follow.

For each of the strategies presented, specific tactics, or courses of action, are suggested as a departure point for further discussion. They are tailored explicitly for a state with tight fiscal constraints and involve very little in the way of new expenditures. More might be accomplished if we had greater resources, and less may be accomplished if our resources shrink further.

The issues themselves are occasionally controversial, the choices difficult, and within our own ranks we do not agree totally. We will have done our job, however, if this document helps Montanans participate in the process of finding the right economic course for the state as we move into the next century.

The Governor's Council on Economic Development

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**MONTANA AT 100:
A LEGACY OF EXTREMES**

Montana's growth...conforms to the patterns of the land itself. For every pinnacle there is an equally impressive declivity. For every sudden rise, a sudden fall.

K. Ross Toole
MONTANA: An Uncommon Land

For more than 100 years, Montana has been a place of extremes--of soaring beauty and grinding hardship, of timeless riches and sudden impoverishment, of pioneer individualism and external economic control.

Throughout its first century, Montana's economy reflected these extremes. Settlers arrived, lured by the promise of land and opportunity; yet occasionally, like this year, some just stood witness while crops died of thirst. Early trappers and prospectors took risks and some won; yet distant landowners foreclosed the future by closing a mine or a mill. Whatever the cause, however, the effect can produce a sense of powerlessness over events, a perceived lack of control over economic destiny.

In the face of these changes, however, Montanans persevere. Past experience confirms that the economic weather will change sooner or later.

And indeed it has. The past two decades have been typical of the roller-coaster ride Montanans have been on for more than a century. The 1970s were a classic Montana boom: driven by high commodity prices, the state's population, employment, and income grew dramatically. When the 1980s arrived, commodity prices generally declined and the economy seemed to vacillate--declining, then rising, then dropping again after 1984. Today, as the 1980s end, the economy is on its way up again. Wood products output is at an all time high, metal mining is profitable, coal sales are strong, and travel and other services are growing.

But the comeback has been harder this time. When the national recovery began in late 1982, Montana rode the rising tide through most of 1984, but a series of shocks in the traditional resource industries--the 1985 drought, the drop in world oil prices, the closing of two meat packing plants and a decline in wood products employment--pushed the state into an economic backwater. In the end, the state created its own recovery--spurring the creation of new businesses, rethinking the competitive position of traditional businesses, and developing new markets for Montana products both in the United States and throughout the world.

After a century of being at the mercy of economic forces beyond its control, Montana's economy is changing. This is the story of that change--its history and the opportunities and challenges it presents.

The Last Boom

During the 1970s, some thought that Montana finally had achieved a position of lasting advantage. Growth in Montana outstripped the rest of

the nation. Employment grew by 32 percent, compared to only 25 percent nationally. Income grew by 57 percent (inflation adjusted), but only 44 percent nationally.\1 Growth was strong in high-income, goods-producing industries like energy resource mining (but not metals), construction, and manufacturing, and even stronger in transportation, health services, business and professional services, and public services.\2 Only in agriculture did employment decline, although farm income grew sharply between 1971 and 1973 and between 1977 and 1978 (falling between 1973 and 1977).\3 For the first time since 1910-1920, more people moved into Montana than moved out. The future looked bright.

The Erratic 80s

A combination of back-to-back national recessions, a national crisis in agriculture, and slumping world energy prices, however, jerked the boom to a halt as the 1980s began.\4.

The contrast between the '70s and '80s is distinct; no region in Montana escaped the change:

Region	Average Annual Employment Growth (%)		
	1969-1979	1979-1986	1986-1987*
Billings	5.6	1.1	-0.7
Bozeman	6.2	2.2	-1.2
Butte	0.9	-1.0	1.9
Glasgow-Wolf Point	0.7	-0.4	-1.4
Glendive-Sidney	2.1	-1.0	-7.2
Great Falls	2.1	-0.7	0.2
Havre	2.7	-1.3	-0.7
Helena	4.9	2.1	2.6
Kalispell	4.5	1.4	2.6
Lewistown	1.0	-0.2	-1.8
Miles City	2.8	0.5	-3.8
Missoula	6.2	0.7	2.0
MONTANA	3.6	0.5	0.2

* Excludes self-employed jobs, understates actual employment growth.
Source: U.S. Bureau of Economic Analysis and Montana Department of Labor and Industry.

Since 1979, the goods-producing sectors of the economy (agriculture, mining, construction and manufacturing) have lost about 12,000 jobs, and total worker earnings (adjusted for inflation) in these industries have dropped about 25 percent.\5 Growth in service industries, however--with 26,000 more jobs in 1987 than in 1979--offset this job decline. Although employment in the service sector grew, total worker earnings for this group of industries, adjusted for inflation, declined slightly between 1979 and 1987. Earnings in service sectors such as wholesale/retail trade and railroad transportation

declined, while inflation adjusted earnings increased for health and other consumer services, along with various business services.\6

Montana's economy as a whole, however, has not kept up with the rest of the nation. Per capita personal income in Montana (in constant 1987 dollars) remained well below its 1979 level until a rise in agricultural income and a net outmigration of people (which decreased the population portion of per capita income) lifted the figures in 1986 and 1987.\7 However, average earnings per worker--what Montanans earn for the work they do, as distinct from property income or transfer payments like Social Security--have declined across the board, in farming and non-farming industries, and in goods-producing and service industries alike.\8 Among our neighbors, only Idaho's per capita income is consistently lower.\9 In the nearly 40 years from 1948 to 1987, per capita income in the state dropped from about 100 percent of the national average to 80 percent.\10

In short, the economic recovery experienced elsewhere in the nation since 1982 largely has passed Montana by.\11

Slower economic growth inevitably results in increasing poverty. In 1978, 12.6 percent of Montanans lived below the poverty line; in 1985 the figure was 16.1 percent, 2 percentage points higher than the national average.\12 Despite this, the number of people on welfare in Montana is relatively low: just over 3 percent of the population (9,300 families) received Aid To Families With Dependent Children (AFDC) in fiscal 1987, ranking the state 31st nationally; and 7.5 percent of the population (22,000 households) received food stamps, ranking the state 22nd.\13 Nevertheless, AFDC costs in Montana doubled between 1982 and 1987: 50 percent came from the increase in the number of families on the regular AFDC program; 28 percent came from extending welfare eligibility to families with an unemployed head (a program roughly half of the states have adopted to help keep families together and that new federal legislation will require of all states by 1991); and the remainder came from the increase in monthly benefits.\14

Montana's historical pattern of net outmigration remained as the other inevitable result of the 1980s economic stagnation. Since 1980, about 29,000 more people have moved out of Montana than have moved in, with most of this loss occurring since 1984.\15 Total population has increased from 787,000 to 809,000, however, as a result of an excess of births over deaths that was larger than the net outmigration.

More Than Just Another Cycle

Between 1979 and 1987, non-agricultural wage and salary employment declined in only six states (Idaho, Iowa, Louisiana, Montana, West Virginia and Wyoming).\16 Interestingly, all these states are major natural resource, commodity-producing states. And that point raises some important questions: Are the 1980s just one more downward swing in Montana's cyclical natural resource-based economy? Is Montana just repeating its historical pattern? Or, on the contrary, are the very recent improvements in metal mining, coal production, and timber production signs of a new upswing in Montana's economic fortunes?

Determining the answer is not simple.

Sectors that have been particularly hard hit nationally during the 1980s disproportionately contribute to Montana's economy. The proportion of state income represented by farming in Montana in 1980, for example, was 210 percent greater than the proportion of national income from farming. The percent of state income from mining was 130 percent greater than the proportion nationwide.\17 Naturally, the decline of many natural resource industries during this decade affected Montana more than most other states.

But that is only a partial explanation. Certainly some of the trouble is that more of our employment is distributed among nationally "declining" (or below average growth) industries such as agriculture than among "advancing" (above average growth) industries compared to the nation as a whole, i.e., it is a problem of the mix of industries in Montana. The rest of the trouble is caused by the change in the share of employment that Montana's declining and advancing industries have in relation to their national counterparts, i.e., loss of national market share.

Estimating the increase in employment since the decade began is difficult. A sample survey conducted nationally for the U.S. Department of Labor suggests that roughly 21,000 more Montanans worked in 1987 than in 1979. Focusing on job creation rather than on the number of people working, the U.S. Department of Commerce calculates that approximately 14,000 additional net jobs existed in Montana in 1987 than existed in 1979.

It is, however, less important to know exactly how many more people are employed in Montana today than in 1979 than it is to know how well the state is competing in employment growth compared to the nation as a whole. And here resides an interesting story.

If Montana's economy had grown at the same rate as the nation as a whole between 1979 and 1987, for example, it would have had 63,000 additional net jobs in 1987 than it had in 1979. But the U.S. Department of Commerce's data show only slightly more than 14,000 net new jobs.\18 The data series used, however, is less relevant, in this case, than the pattern of where jobs were created and where they were lost during this period.

Most Montanans would argue that the state did not keep up with the national average because its employment was concentrated more in declining industries than advancing industries, compared to the rest of the country. And they would be right, but only up to a point. Montana's basic industries--industries that bring new money into the state by exporting products or services (agriculture, mining, heavy construction, most manufacturing, railroads, hotels and motels, and the federal government)--collectively lost 15,000 jobs between 1979 and 1987. If they had grown at the same rate as the national economy during this period, they would have added 18,000 jobs. About 75 percent of the 33,000 total job shortfall in basic industries was caused by the fact that most of them were declining industries nationally, and Montana did not have enough advancing industries such as data processing and other business and professional services marketed out-of-state to counteract that decline. The other 25 percent of the shortfall resulted primarily because Montana's service-producing basic industries (federal agencies including military, hotels/motels, and railroads) lost market

share to similar establishments in other states. Federal agencies were the principal losers among Montana's service-producing basic sectors.

Not all of Montana's basic industries declined or lost market share during this period, however. Some manufacturing industries grew (apparel and other textile products, furniture, nonelectrical machinery, and sporting goods, for example), while other industries declined less steeply than their counterparts elsewhere in the nation, thus increasing market share (including agriculture, metal mining, and coal mining).

The picture for the rest of Montana's industries--building construction, local transportation and utilities, wholesale and retail trade, and local private and public services--is less clear. These industries grew, but not as fast as their counterparts in the nation as a whole--adding 29,000 jobs instead of the 45,000 that would have been added had they grown at the national rate. It is difficult to know all the reasons for the slower growth, but it appears that the decline in the basic industries, upon whose income these non-basic businesses depend in part for support, caused some, and perhaps most, of the shortfall.

This analysis reveals that the fortunes of natural resource industries still affect the Montana economy greatly, although to a lesser extent than in the past. Because these industries respond principally to national and international shifts in demand and price, there is little Montanans can do to influence them, industry arguments about taxes and other state business costs notwithstanding. In addition, some of Montana's basic industries are not competitive. They can be with substantial investments in modern production technologies, but those efficiency investments translate into fewer future workers.

In sum, Montana's economy is changing. Understanding why and how it is changing is crucial.

A NEW MONTANA ECONOMY

Past experience tells us we are in another recession, and the resulting change is not accommodated easily. People lose jobs, families face hardships, businesses shrink or close, communities struggle. These events are known only too well. But this time, past experience is no guide.

This time, a new economy is evolving in Montana. As the state becomes more diversified, it depends less on its traditional natural resource-based industries. Resource industries themselves are changing, becoming more specialized, more technologically advanced. The relative importance of services is increasing also, following the national trend. And Montanans are creating their own businesses at record rates--rates greater than those in neighboring states.

After decades of looking for signs of the next externally driven economic slump, Montana today can adapt to new realities, overcome the constraints of the old, and take control of its own economic destiny. The new realities include: a global economy in which the state actively participates rather than rues its lack of control; increased international competition for more goods and services; increased competitiveness of modernized and downsized traditional industries; and the increasing importance of individual entrepreneurs.

These changes, both directly and indirectly, rebound in every corner of the state's economy--no enterprise is too small, no community too remote, no occupation too "traditional" to be immune.

Technology and the Global Economy

In an increasingly global economy where the technology for producing everything from wheat to computers is available worldwide, U.S. businesses can no longer compete on the basis of price alone. Third World countries--willing to pay their workers pennies per day or able to subsidize their production in order to gain a share of world markets--make competition stiff.

Except for agriculture, Montana now is a minor player in the global economy, ranking 46th in foreign export manufacturing jobs in 1984, for example.¹⁹ As long as the number of foreign export related jobs remains low, economic opportunity will be restrained and even the smallest local businesses will be affected.

Increasingly, competitiveness in the global economy--and generation of income and jobs from export trade--requires producing the highest quality or most technologically advanced products and services. For Montana, this means that traditional commodity-producing industries like timber, agriculture, and mining have had to out-innovate their international competitors by developing production processes that are more technologically advanced and more efficient than those used elsewhere. And that is precisely what those industries have been doing since the mid-1980s--modernizing and restructuring to become more competitive.

It is an old story that agricultural production has increased steadily for years even as the number of farmers and the number of acres of farmland have decreased. The same story applies more recently to other Montana industries. Production and sales in Montana's wood products industry were at record levels for 1986 and 1987, partly because of significant modernization and mechanization investments. Growth in metal mining is strong, as new technologies make both new mines and previously abandoned mines profitable again. The Butte copper/molybdenum mine has reopened under new ownership and is producing at a cost per ton that is nearly half of what it was only a few years ago. Despite soft markets, and perhaps because of tax incentives, Montana coal producers had a banner year in fiscal 1988, producing at highly competitive rates.\20

In these and other industries, Montana regained its competitive edge through an economy-wide commitment to investments in state-of-the-art technology, quality and, where possible, value-added processing. But there is a cost to this progress: employment in these industries may never again reach previous levels, much less grow beyond them. The wood products industry in Montana, for example, lost about 3,000 jobs between 1978 and 1987, even though 1987 was a record year for production. As these industries become more efficient, each new peak in production or sales results in fewer Montanans being employed. As a result, the growth of industries that derive their support from the wages of employees--retail and wholesale businesses, for example--also is constrained.

In the end, however, what looks on the surface like an economy in trouble is just the opposite. Resource industries are adjusting and responding to the global challenge, service industries, following the national trend, are on the rise, and more Montanans than ever before are creating businesses and jobs. Montana's economy is restructuring, diversifying, and positioning itself to participate in the new world economy.

The New Pioneers: Montana's Entrepreneurs

As Montana's traditional industries restructure, a striking pattern of entrepreneurship--rapid growth in self-employment and new business formation--counterbalances the decline in conventional wage and salary employment.

One in four Montanans today is self-employed.\21 In fact, were it not for self-employment growing by 25,000 jobs between 1979 and 1987, the loss of 11,000 conventional wage and salary jobs would have meant a net job loss for the period. In addition, while about 20 percent of total self-employment is agricultural, all of the growth in self-employment since 1979 has been nonagricultural.

Certainly some of this growth in self-employment is a kind of "entrepreneurship of necessity"--people who create their own businesses because they lost a salaried job. But necessity is not the only explanation; the trend is too pronounced. For many Montanans, self-employment is a way of maintaining or reclaiming an independent, self-sufficient way of life that has long been valued. It is a way of expressing creativity, providing options and economic diversity. And, it is a way to live in Montana.

The entrepreneurial way of work shows in the data. Since 1979, total nonfarm self-employment income increased about 30 percent, from \$750 million to \$1 billion--more than the total earnings generated by agriculture and mining combined.\22 While total income has increased, income per job has decreased, reflecting the fact that in their early stages such businesses often require reinvestment of capital that increases equity but produces little income, or they tend to be part-time and too young to generate significant income.

Self-employment can be a stepping stone to incorporation and business growth, although no data are available on this process in Montana. We do know that new businesses are formed in Montana at a rate significantly faster than the nation as a whole. Montana ranked 10th nationally in 1987 in new business formations (per 10,000 workers)--specifically, in the number of businesses that were formed after 1983 and employed at least 10 people in 1987.\23 Using Unemployment Insurance data, Montana's Department of Labor and Industry found that nearly 5,000 new businesses were formed between June 1984 and June 1986. Almost 90 percent of these businesses were still operating after two years.\24

That's the good news. The bad news is that these new businesses are not growing very fast. Although Montana ranks 10th nationally in new business formations, it ranks 48th in new business growth.\25. Simply put, Montana has two economies--one new, one old; one advancing, one declining. Montana's new economy, however, is not growing fast enough to offset the losses caused by the decline of its old economy. How to advance and support that growth is Montana's central economic challenge.

STRATEGIES FOR STRENGTHENING MONTANA'S NEW ECONOMY

The essential difference between Montana's old economy and its new one is who controls the future. Much attention has been given to the actual or perceived effect of the century-long domination of Montana by "outsider" corporate interests--railroad, timber, and mining companies, oil and gas companies, international grain merchants, and the federal government, among others.

As domestic and international markets become more fragmented and more intensely competitive, however, the key players change and so do the issues that matter. Throughout the country, the behemoths of industry are "downsizing" and restructuring to survive. Those who do not, go under. Since 1980, for example, the "Fortune 500" companies nationally have cut 2.2 million jobs, and one-third of the companies on the list in 1970 have disappeared (or been absorbed). The same process is underway in Montana: large firms are cutting jobs, small firms of 20 employees or fewer are adding them.\26

New Players, New Roles

As the key players in Montana's economy have changed, the roles of state and local government have changed as well. Montanans have welcomed the reduced influence of large natural resource and transportation companies, but have been slow to understand and help meet the very different needs of the new companies that are driving the economy. In the past, there was little that state and local government could do to influence the direction of the major companies that dominated Montana's economic fortunes. In fact, in most areas of major commodity development this is still true today--there is not much that state and local government can do about OPEC oil prices or international wheat prices, for example.

In contrast, the new, smaller, innovative companies that are growing in Montana today--including some in traditional natural resource sectors--depend significantly on the policies of state and local government for their survival and growth. That does not mean that state government can create jobs and economic development. That is the job of Montana's businesses. But the state does have a lot to do with whether businesses succeed, because what is important to business development has changed along with the economy itself:

- o These businesses generally depend upon the state and local educational system to produce a work-ready labor force and entrepreneurs;
- o Unlike large corporations, the new businesses are less able to afford massive training programs and thus depend more on local and state job training programs;
- o They depend on the ready availability of capital from local sources, especially at start-up and early expansion stages;
- o They rely on local and state government to ensure that infrastructure--water, sewer, roads, bridges, airports, and so forth--is in good condition and able to expand with their needs;

- o They are attracted to and depend on a steady stream of technologies and innovations from state-funded universities and research centers;
- o Their ability to attract key employees depends on the commitment of local and state officials to create and maintain a high quality of life;
- o And their ability to thrive depends on the fairness of the state and local regulatory environment and--for would-be entrepreneurs--the degree to which those governments are able to provide management and market development assistance to help them get started and grow.

Montana's economic turnaround is going more slowly than desired, but not because the state does not help new businesses to develop or existing businesses to expand. Indeed, the state's Build Montana programs address the needs of business.

The slow turnaround, rather, stems from several factors. First, the economic building blocks are not yet fully developed because the new economy requires different "blocks" than the old. Second, Montana's capital situation has changed.

In the past, when important economic decisions were made by outside forces, there was little need to develop in-state development capacity. But today, gaining control over the state's economic destiny depends on investing in these building blocks and maintaining them over time.

Key Strategies For Developing Montana's New Economy

For many new, but slow-growing businesses, and for traditional industries competing in the global economy, the crucial issues are those that relate to the quality and condition of economic development building blocks--education, training, capital, infrastructure, amenities, and local government capacity.

Consequently, as Montana begins its second century, five strategies are crucial to its economic future:

- I. Investing in the Workforce
- II. Encouraging and Supporting Entrepreneurship and Business Innovation
- III. Building and Maintaining Physical Infrastructure
- IV. Strengthening Local Government Fiscal Capacity
- V. Strengthening State Fiscal Capacity

Few of the strategies and tactics discussed here involve new expenditures. Inevitably, investing in people and economic infrastructure will require some new spending. But elected officials will determine what the state can afford to spend and where. This report focuses on policy changes, not on spending. Much can be accomplished simply by doing things differently.

STRATEGY I: WORKFORCE INVESTMENTS

In 1988, Montana was ranked by a major national study as having the best-educated workforce in the nation.\27 Combining high school graduation rates, college attainment levels, and adult literacy rates gives Montana the nation's best human resources. Montana also has a highly skilled workforce. In 1986, more than 25 percent of Montana workers were classified in the managerial and professional category--well above the national average and above neighboring states.\28 A 1983 study by McKinsey and Company also found Montana workers highly skilled, the most productive in all manufacturing activities of any of the states in the region, competitively priced, and low in absenteeism.\29

The high ratings are heartening, but Montanans must not become complacent. For one thing, other states are developing substantial new workforce initiatives and investments. For another, the state's evolving economy demands ever higher skills. As Montana's economy moves away from the production of raw materials to more complex, more highly valued activities, people become the most important factor in the production process. Furthermore, the skill requirements of jobs in Montana's growing industries --including many in the service sector--are increasing rapidly and unpredictably. In 1970, only half of all jobs required the competence of a high school graduate; before the end of the century that figure will rise to 75 percent. Almost all new jobs today require a high school education. And, while Montana has a relatively low dropout rate (29th in the nation), those Montanans who lack such an education will see their earnings, relative to those with better educations, drop sharply in coming years.

Strictly in economic terms, Montana's workforce is one of the most important development assets in its portfolio, and maintaining that asset must be its highest economic development priority. Maintaining a better-educated, better-skilled workforce is also the surest way to reduce poverty and create new economic opportunity for the people most at risk in Montana's changing economy, and to reduce public assistance costs in the process.

The Workforce Investment Strategy contains two basic tactics: (1) raise the educational attainment and skills of tomorrow's workforce, and (2) strengthen the earning capacity of poor people and reduce welfare caseloads. Within each tactical area several possible courses of action are presented for discussion.

Workforce Tactic #1: Maintain and Enhance the Educational Attainment and Skills of Tomorrow's Workforce

When education and literacy burst upon the scene as major economic issues a few years ago, policymakers immediately focused on the inputs of education. They instituted rigid teacher qualification requirements, developed detailed curriculum specifications, and pumped money into teachers' salaries, educational materials, computers, and so forth.

Except in the most chronically under supported school districts, exclusively focusing on inputs will not create excellence. A good school involves a unique blend of chemistry, composed of talented teachers, dedicated

and creative administrators, and motivated students and parents. It is a living, organic unit. Excellence is achieved when teachers, administrators, and parents focus on the outputs of education--what they want students in their community to know and be able to do as a result of their schooling--rather than on the inputs. When freed of prescriptive formulas and regulation that characterizes much of the public education system today, and measured instead for their ability to draw together human and physical resources to develop appropriate curricula and to assess students' progress toward meeting educational goals, teachers and administrators become, in effect, educational entrepreneurs. The beneficiaries are the students, the communities they enter upon graduation, and the teachers themselves, who rediscover why they became teachers in the first place.

This does not mean that some input issues--teacher salaries, class size in certain instances, physical plant, teaching materials--are not important. Recent cuts in school spending in some communities will impact the future workforce negatively. Money is needed. But money alone will not create excellence. And excellence must be the goal if individuals and businesses in the state are to prosper.

There are several courses of action to pursue, without dramatic increases in funding, to assure that Montana maintains its high-quality workforce. Many of these performance-oriented ideas are already in place and successful elsewhere in the nation. In some cases, suggested actions already exist in Montana, and deserve additional recognition and support.

Adopt and Regularly Upgrade School Accreditation and Graduation Standards. The Montana Board of Public Education has proposed new accreditation standards based upon outcomes--what students are expected to know and be able to do as a result of their schooling.³⁰ It also has proposed graduation standards for students, with upgraded requirements for science, computer literacy, and foreign languages, for example. These are important steps and the board deserves support in these objectives.

Give Schools More Discretion Over Education and Administration. Flexibility in hiring, salaries, staff deployment, development and use of facilities, and the allocation of funds is a prerequisite of innovation and excellence in education. Montana has gone far to achieve these objectives. But to retain its high ranking in workforce education and skills, more could be done. For example, in the Miami-Dade County, Florida, school system, each school gets a lump-sum budget and the principal and a faculty management team decide how to use it. A similar pilot program is underway in Montgomery County, Maryland. In Hammond, Indiana, "design teams" of parents, teachers, administrators, and students decide on spending priorities. In Montana, the Board of Public Education has proposed reducing state-set restrictions as the capacity to monitor school performance develops. The board should aggressively pursue this initiative and encourage local school districts to follow suit.

Publish Annual Reports on the Performance of Public Educational and Private Training Institutions. If schools receive flexibility to craft programs within broad guidelines, performance standards will be necessary. Administrators need to know how their programs compare to those in other institutions; teachers should know if their students are improving;

students need to know how their competence levels stack up against their own expectations and those of the community; and parents will want to know the relative merits of different schools before they select one for their children (see below).

Performance reports could help both the producers and consumers of education to knowledgeably evaluate these objectives. The Board of Public Education could publish an annual "Montana Education and Training Report" that lists not only such things as standardized test scores, but also job placement rates (from Unemployment Insurance file data), college acceptance rates, dropout rates, and even such school-related issues as teen pregnancy rates. The Board of Regents could compile similar reports for post-secondary institutions.

Provide Performance Bonuses. Schools that perform well need to be rewarded. A statewide fund, supported jointly by government and private industry (through tax-deductible contributions), might be established to recognize schools that have achieved dramatic performance improvements over the previous year. In 1985, the Governor recommended an Excellence Fund for a similar purpose, to be funded with coal severance taxes, but it was not adopted. Under such a proposal, however, schools would compete against themselves, not against other schools with different local conditions or educational resources. Awards would recognize the school as a team, not as individuals, and institutions would have complete discretion in how they used their awards, reemphasizing the principle of flexibility. Schools unable to achieve excellence within funding limits because of cultural or environmental factors would be able to draw upon special state assistance.

Because of current litigation, Montana is reviewing its overall school finance system. The advisory council appointed by the Governor could use this opportunity to tie funding to the expectations Montanans have for their schools as set forth in the new accreditation standards.

Allow Parents to Choose Among Public Schools. When parents can choose which public schools their children attend, schools tend to strive harder to meet parents' and students' needs, and to teach more effectively. The National Governors Association has called upon states to introduce choice into their public educational systems, and several states (including Minnesota and Arizona) have already done so. In thinly populated areas of Montana, parental choice is difficult, but not impossible. In other rural areas of the nation (rural Minnesota, for example), innovative transportation services have opened up effective alternatives for students. Moreover, there is no reason why individual school buildings could not house two or more public "schools" with differing educational objectives or management styles, thus creating an atmosphere for educational excellence and offering parents and students a choice.

Workforce Tactic #2: Strengthen the Earning Capacity of Poor People and Reduce Welfare Caseloads

Poor people--those who receive public assistance in some form and those who do not--are culturally, socially and economically diverse. For about half of Montana's poor, poverty is a temporary condition, the result of sudden illness or the loss of an income-earning spouse, and they return to the mainstream after a short time.\31 This pattern is reflected, in part, in the Aid to Families With Dependent Children cases, half of whom have been receiving benefits for less than three months.\32 In these cases, the welfare programs perform the function for which they were created: to provide a "safety net" while people get back on their feet again.

For perhaps another third, economic independence is more difficult to attain. They lack the basic skills, experience, or aptitude to obtain and hold the kind of work that will support their families above the poverty level. They work--often full time--but do not receive public assistance unless illness or sudden job loss forces them to. Because they lack basic skills, returning to the workforce is more difficult.

Finally, a relatively small number of people--roughly a sixth of those receiving welfare--are long-term dependents. Many are medically unable to work. Many more are single women with several young children. Native Americans are disproportionately represented. Sixty percent of the welfare grants in Montana go to families of three or more individuals.\33 With limited skills, children to care for, and other personal barriers to overcome, these people depend on public assistance longer, often working when possible, but never fully breaking free of the system.

Compared to most other states, Montana takes relatively good care of its poor. But, compared to other states, it is less successful at removing the barriers that keep people dependent upon welfare, for at least three reasons. First, it assesses the needs and ability to become economically independent of only some welfare clients. Second, mostly because of federal program regulations, it does not concentrate resources on training and educating those who need it most. And, third, as the system is currently designed, mothers must forfeit child and health care benefits they receive while on welfare when they reenter the workforce. Most often, the marginal wages of an entry-level job are not sufficient to provide replacement benefits. Thus these women find themselves in a double bind: to work with no child and health care benefits and jeopardize their children's well-being, or to remain on welfare. As a result of these barriers, welfare caseloads are higher than necessary and welfare costs have increased steeply.

New federal welfare reform legislation passed by Congress September 30, 1988, is designed to remedy this situation. The legislation requires states to establish education, training and work programs designed to move welfare recipients from welfare to full-time jobs. Education and job-linked training are the best tools for raising the incomes and improving the employment prospects of the long-term poor. The legislation also guarantees mothers the child care and health care coverage they need to participate in the program. In addition, it stiffens enforcement of child-support payments in families

where the parents are divorced.

The Governor's Human Services Delivery Task Force and the Joint Interim Subcommittee on Welfare are considering ways of returning people to the economic mainstream in Montana and assigning responsibility between state and local governments as are members of Montana job training councils. But more remains to be done. As growth in the labor force slows and the skill requirements for all jobs increase, Montana businesses will have more difficulty finding qualified workers. Attention, therefore, must turn from short-term, and often unsuccessful, job placement to upgrading the education and skill levels of the dependent population. Two promising broad courses of action are presented.

Assess Needs and Allow Choice. Social service agencies need to assess welfare dependents' personal and economic strengths and weaknesses and encourage them to choose appropriate routes toward independence, providing financial support along the way. Following the lead of Massachusetts, California, and Michigan, many states are using public assistance programs as avenues to independence by granting welfare recipients increased control over their own futures. The same can be done in Montana, but first better information about welfare dependents is needed; better information on the prerequisites, costs, and performance of education and training programs in the state is required; and a means by which recipients can make investments in themselves is essential. Michigan, for example, is instituting an "Opportunity Card" for welfare recipients by which they can draw down funds from an account established on their behalf to pay for whichever services (from placement to training to further education) they choose as their route out of dependency. The resulting empowerment--brought about through choice combined with individual responsibility--provides one road to independence.

Montana currently is obtaining federal waivers to permit welfare recipients to go to college without forfeiting benefits. This is an important first step because those who complete their courses are unlikely to return to welfare again. To be most effective, this new opportunity must be marketed widely to welfare clients.

Offer a Wide Range of Competitive Services Under Performance Contracts. The principles for encouraging excellence in education--measuring and rewarding performance and providing greater administrative discretion and client choice--apply equally to fostering excellence in social services. Competition in the delivery of services would both increase efficiency and decrease costs. At present, for example, there is limited competition in programs to train welfare clients. To foster competition, welfare recipients could be given vouchers by which to purchase training services from organizations based upon how successful those organizations are at placing people in well-paid, enduring jobs--an approach proving effective in other states.

Finally, Montana must continue to experiment with new ways to help low income people create opportunities for themselves. Programs are underway in Missoula and Bozeman to help welfare recipients consider self-employment or business development. These programs offer a small but significant route to independence for some of Montana's welfare dependents.

STRATEGY II: ENTREPRENEURSHIP AND BUSINESS INNOVATION SUPPORTS

The brightest spot on Montana's economic horizon is the steady increase of self-employment and new business development in the state. The most troubling problem facing the state may well be the slow growth of these same businesses. Montana's entrepreneurs face several significant hurdles. Perhaps most troubling is the tendency of both private and public development practitioners to focus on recruiting one of the handful of branch manufacturing plants that relocate in a given year, rather than on the needs of the thousands of businesses already in the state. Other major hurdles include lack of public awareness of the importance of individual entrepreneurship in the economic history and future of the state, limited access to business management and marketing assistance, limited utilization of research and technology information, and limited or restricted access to investment capital. In Montana, there are problems and opportunities in each of these areas.

The Entrepreneurship/Innovation Strategy contains five tactics: (1) increase the visibility of Montana entrepreneurs, (2) assure the availability of business management and marketing assistance, (3) improve access to capital for business development, (4) harness the resources of the higher education system to spur development, and (5) reduce the regulatory barriers to new business creation.

Entrepreneurship/Innovation Tactic #1: Increase The Visibility of Montana Entrepreneurs

Montana shares the tradition of entrepreneurship: people willing to bet their future on an idea for a new product, a new service, or a new market in which to sell. A century of large corporate employers and international commodity industries obscured the contribution of the individual entrepreneur. Economic statistics clearly show, however, that these individual entrepreneurs--Montana's small businessmen and women--quietly are creating Montana's next economy.

Increasing the visibility of Montana's entrepreneurs will draw attention to the opportunities in Montana for new business development, with little expenditure of money. Montana's educational institutions and political leaders can recognize and help teach the lessons of individual achievement in business. This recognition and instruction creates a climate that fosters new enterprises and helps existing businesses to grow.

There are a number of ways to achieve these goals. First, create Governor's Awards for Entrepreneurial Achievement for individuals and businesses that have created new jobs, developed or applied new technologies, created new products, or opened new markets for Montana products. The award selection process, which could be both regional and statewide, should emphasize new or expanding businesses and be managed by a distinguished panel of leaders from within the state, and include at least one expert from out of state (for example, an editor of a major small business magazine).

A second step for increasing the visibility of enterprise development, and creating new role models in the process, would be to introduce entrepreneurship--and leading entrepreneurs--into the civics, economics, and business classes in our public high schools, vo-tech schools, colleges and universities. For the past six years, the Montana Council on Economic Education has promoted this concept to students and teachers. Business and enterprise development have been promoted at summer schools, conferences and other educational forums throughout the state. The Montana Ambassadors might co-sponsor similar activities.

Entrepreneurship/Innovation Tactic #2: Assure the Availability of Management and Marketing Assistance for New and Expanding Businesses

New businesses fail, by and large, not because they lack a market for their products or services, but because they do not know how to succeed. They often lack the business management or market development experience necessary to stay in business. Also, new business owners generally are working so hard just to stay afloat that they don't have time to seek the assistance they need, even if they knew where to get it.

But, help is available, through the Business Assistance Division of the state Department of Commerce, through the Small Business Development Centers it has created in Helena, Glendive, and Kalispell with the support of the U.S. Small Business Administration, through the Center for Entrepreneurial Studies at the University of Montana, and through vo-tech school programs such as the one currently underway in Missoula, among others.

The more diversified Montana's economy becomes, the more fragmented domestic and international markets become, and the more the economy is driven by relatively small companies, the more these technical assistance services will be needed. As a first step toward improving the accessibility of these services, Montana should commit itself to strengthening the quality, quantity, and geographic distribution of state or local business assistance programs. The Department of Commerce, working with local educational institutions and private business incubators, can do much to increase the success rate of new businesses in the state.

These services need not be provided only by government or educational institutions, although it is often easier and sometimes more efficient for them to gather and disseminate information. Nor must assistance necessarily be provided as a public service. If the assistance is valuable, businesses generally are willing to pay a fee for it. The internationally recognized Women's Economic Development Corporation (WEDCO) of St. Paul, Minnesota, is a good example.

WEDCO, a private, nonprofit business assistance organization run by professionals with business ownership experience, provides direct assistance to would-be start-ups. WEDCO assists in developing business and financial plans, in obtaining bank financing, and maintains an oversight function during the initial years of operation. Since 1984, WEDCO has helped launch 600 new businesses, expand 300 others, and create 1,000 new jobs. About a quarter of WEDCO's income comes from client fees charged once financing is secured.

Montana needs to explore opportunities for creating a publicly chartered, privately operated statewide system of business development companies--non-profits loosely modeled after WEDCO (only not limited to women) operating in a number of Montana communities. Such a system could be capitalized jointly by the state, by federal and private grants, by client fees, and by royalty financing, and could obtain investment capital for its clients from conventional banking institutions based on the strength of the business proposals its clients create. [NOTE: Legislation creating this system would need to be carefully constructed to meet the requirements of proper legislative delegation and fiscal authority imposed by the recent state Supreme Court decision related to the Montana Science and Technology Alliance bonding programs.]

Entrepreneurship/Innovation Tactic #3: Appoint a Temporary Financial Services Commission to Review the Regulations Governing Competition in Montana's Financial Industry--Including Intrastate and Interstate Banking--Remove the Barriers to the Industry's Growth, and Increase Access to Capital for Montana Businesses

Montana banks, as a whole, generally earn higher profits than banks in adjacent states and other mountain states, and usually are much more profitable than the national average.\34 Within Montana, banks in rural communities consistently earn a higher rate of return than banks in large communities. Montana banks, however, invest a lower share of their assets in local businesses and individuals than do banks nationwide, and invest instead in low-risk, out-of-state income earning assets such as corporate and government bonds. Montana banks recently were ranked 43rd in the nation in their ratio of loans to equity.\35

The smallness of Montana banks generally--with assets averaging only \$41 million, compared with a \$268 million average in Idaho, for instance--means that they frequently cannot handle internally the larger, longer-term business loans, or loans requiring specialized knowledge (such as import-export loans).\36 Thus, most of Montana's banks are unable to provide the kind of "full service" financial services that banks elsewhere have developed.

Certainly there are aggressive, well-managed banks in Montana--banks that are investing a significant portion of their resources in loans to local individuals and businesses, while still maintaining an acceptable loan-loss ratio and a competitive rate of return for stockholders. But these appear to be the exception, not the rule. Why?

The answer--and the solution to Montana's business capital access problems--is still not clear, and continues to be obscured by heated and sometimes uninformed debate over the issues of mergers and consolidations, interstate banking and intrastate branching. One possibility is a temporary, but high-level and professionally staffed, Financial Services Commission, created to develop for legislative consideration a strategy designed to encourage modern, responsible banking innovation and provide Montanans the benefits of a competitive financial system.

The Temporary Financial Services Commission should consider, among other options, creating a loan-loss insurance fund, modeled after the Michigan

Capital Access Fund, that--through premiums paid by banks, borrowers, and the state--would ensure portfolios against bad loans and thus increase banks' willingness to make business loans. The commission should also consider creating a publicly chartered, privately managed Business and Industrial Development Corporation capitalized by banks, private investors, and the state (acting as an investor) to increase the availability of medium risk/medium return capital--which falls between the investment areas of venture capital companies and conventional financial institutions.

The commission should study the performance of individual banks and groups of banks (independents, multi-state banks, and in-state holding companies) to determine if there are significant variations in their relative costs of capital, loan-to-asset ratios, and other indicators of accessibility and competition. It should analyze the factors that appear to have influenced the development and success of the most responsibly aggressive banks, and determine what, if any, public sector actions could be taken to stimulate and encourage others to perform similarly.

The commission also should examine legal, tax, and regulatory barriers to the growth and diversification of financial institutions in the state and formulate a plan to provide full service banking.

Entrepreneurship/Innovation Tactic #4: Harness the Resources of the Higher Education System to Promote Economic Development

One of the clearest lessons of recent economic history is the direct relationship between economic development and institutions of higher education. The higher the quality of teaching and research at these institutions, and the more carefully focused they are on technology development, the greater the benefits for the state economy.

As the population of 18- to 24-year olds from which colleges and universities draw their enrollment declines, Montana's institutions of higher education are tailoring their programs to meet the needs of new markets--offering non-traditional courses to non-traditional students and developing research programs that are linked more closely to the needs of the business community. If Montana is to increase its competitive position in the national and global economy, this process must be accelerated. Three areas of activity need to have high priority:

Raise Teaching and Research Standards. In the interest of raising the standards of higher education in Montana, the Board of Regents already has moved to replace the open admissions policy by the Fall 1990 term. The same commitment to quality may be applied to instruction and research. The board needs to reward programs that perform well as well as seek new sources of support, including partnerships with business, perhaps the major beneficiary of research and advanced education.

Just as secondary and vo-tech schools are instituting performance- and outcome-based management systems, so too should our institutions of higher learning, utilizing criteria that reflect the changing realities of education such as teaching excellence, research dollars secured, business partnerships developed, the placement rates of graduates in jobs and schools of further

learning, student performance on standardized tests, and so forth. Once the Regents' system is developed, the board should reward outstanding performance, both among schools and individuals. As one source of discretionary funding for these awards, the state should permit the university system to retain 100 percent of the overhead charged to research contracts, rather than returning half, as it now must, to the state. The amount that this action represents--some \$3 million--is small to the state as a whole, but highly significant to the university system. It could serve as the core of a discretionary fund, which could be matched by industry, to finance grants for programs, research, and student scholarships and fellowships, and to finance performance awards in the form of salary bonuses.

Develop Research Capacity. Montana has begun to develop areas of research expertise that could have significant long-term benefits for the state's economy--MSU's Center for Advanced Materials and the Minerals Institute at the Montana College of Mineral Science and Technology, to name but two. New research and technology transfer resources from the Montana Science and Technology Alliance (once the Supreme Court issues are addressed) and the Montana Agriculture Development Council present significant opportunities for further capacity building. The university system could identify a small number of fields in which it now has, or could soon develop, significant competitive advantage and focus its research resources in those areas, rather than trying to distribute available research dollars across all schools and all areas of the state.

Strengthen Linkages With Business. The new Centers of Excellence, the Advanced Technology Research Park, the Institute for Public Policy at the universities, and the business incubators and business-related training programs at community colleges, move Montana's institutions of higher learning closer to the interests of Montana's businesses and of economic development in general. These linkages should be strengthened and increased, particularly in those areas of research advantage noted above. Finally, the Board of Regents should set aside a fund explicitly earmarked to match private industry sponsorship of research--both to encourage researchers to seek such sponsorship and as a signal to industry of the university system's commitment to industry's needs.

Entrepreneurship/Innovation Tactic #5: Reduce Regulatory Barriers to New Business Creation

Over the course of many years, state regulations designed to achieve once-important ends accumulate and become barriers to competition and new business development. From time to time, reevaluation helps ensure that these regulations still serve legitimate public purposes. Two possible initiatives in this regard include: creating a gubernatorial task force to evaluate occupational licensing and permitting regulations for such enterprises as day care centers, health care activities, telecommunications, agricultural marketing, utility and transportation regulation, among others, to ensure they do not create barriers to entry; and adding a problem-solving "Business Ombudsman" to the Department of Commerce's existing "one stop" permitting and licensing service.

STRATEGY III: PHYSICAL INFRASTRUCTURE CONSIDERATIONS

Publicly provided infrastructure--roads, bridges, airports, water supplies, wastewater treatment, jails and other facilities--is a basic foundation for economic development. But in 1984, the Governor's Task Force on Infrastructure concluded, "For many years, we have taken such key structures...for granted."37

In a large state with a small population, the cost of maintaining infrastructure systems is high. Montana spends \$416 per capita on its highways, for example, the third highest in the nation. The interstate and state-maintained highways are in good condition, but county and municipally maintained roads need work. The 1985 Legislature dedicated 12 percent of the coal tax to highway construction, which will yield an additional \$40 million by 1993. The 1987 Legislature passed a fuel tax increase, which will yield an estimated \$150 million over the next 10 years. In 1984, the Montana Legislative Council reported that Montana needed \$72.5 million to replace structurally unsound bridges and \$27.7 million to repair structurally obsolete ones.

Other pressing needs include building or improving solid waste sites estimated to cost \$150 million, and repairing or replacing several dozen dams owned by the state, cities, or counties. A recent Montana Legislative Council survey identified 264 major water supply projects and 279 local water systems in need of major upgrading in order to meet State Water Quality Standards at an estimated cost in excess of \$100 million.38 In addition, the U.S. Environmental Protection Agency estimates that meeting Clean Water Act requirements will cost Montanans an average of \$53 per capita, though the figure will be higher in some communities.39

Infrastructure policy is more than a search for money. Devising a system for assessing the true value of all projects, given the current condition and likely future demand, will aid in the state's addressing the problem of financing the most needed projects.

More important in the long run, is that while the state has begun to adjudicate water rights, the process defines water rights only in terms of permissible diversions. But if rights are to be transferred, the consumptive use of rights' owners must be specified so it is known what rights can be transferred without impairing the activities of those benefiting from return flows.

Several tactics can be pursued to address these issues and, in so doing, strengthen the infrastructure foundation--and thus the competitive position--of Montana's economy: (1) improve the capital planning and budgeting system, (2) strengthen the infrastructure financing capacity, and (3) create a water rights procedure that expands and facilitates transfer of water rights among all beneficial users.

Infrastructure Tactic #1: Improve Capital Planning and Budgeting

Improve Capital Planning. Infrastructure projects planned, financed and operated through federal, state, and local agencies use a system that often encourages overstatement of needs and understatement of available resources. Consequently, before beginning to search for money, reliable information must be collected about the condition of current facilities, the forecasts of future demand, and the consequences of alternative approaches to construction, rehabilitation, and repair. To increase the accuracy and reliability of capital budget requests, the state might publish and distribute its capital plan, thus implementing the philosophy that full disclosure and debate will generate a capital plan that fits, but does not exceed, reasonable needs. Local officials, legislators, and agency heads will then have accurate information on which to base investment decisions.

Improve the Capital Budget. Most Montana agencies simply list the projects and programs they would like to have funded in the state's biennial capital budget (except for the Highway Department, which prepares a detailed capital budget). Typically the composite does not show the costs of deferred maintenance, the costs of alternative financing methods, nor does it reflect the relationship of individual projects to the state's development goals. Some agencies with capital projects financed by user fees, such as those responsible for water supply, wastewater treatment, parks and recreation, and some permitting, could adapt to changing demands or new technologies more quickly if their budgets were not constrained by biennial line items. An enterprise (lump-sum rather than line-item) budget would permit these agencies to use funds as needs change, permit them to carry over excess funds to build reserves against fluctuating demands, and encourage cost control experiments that would free resources for other uses.

The state needs to modernize its capital budget to ensure that the full costs of projects are displayed, and it should consider the use of enterprise budgets to encourage efficiency and flexibility in infrastructure service agencies.

Infrastructure Tactic #2: Strengthen Montana's Infrastructure Financing Capacity

Until recently, Montana has financed a large share of its capital projects through bonds backed by coal severance tax revenues. But the recent decline of these revenues has eroded that collateral source. Moreover, a stream of initiatives to limit or change taxes or revenues or change the status of the severance tax fund has increased uncertainty. Under the circumstances, new financing policies need to be considered.

The most promising ways to strengthen financing capacity include user-fee backed revenue bonds, more effectively marketed debt, and more competitive underwriting.

Back Revenue Bonds With User Fees. When investors judge the security of the state or a local government's promise to repay its debts--and in the process set the interest rate--they base their decision on the value of the project, the economic base of the community, and the fiscal position and

practices of the community. In part because of the volatility of natural resource industries and their effect on the economic health of Montana communities, anything that will strengthen and stabilize the state's financial position will improve its chances of raising money for needed infrastructure projects at reasonable rates. User fees are an efficient and equitable way to assure investors of the state's financial stability. User fees provide useful "market information" about the demand for the service provided and the need for additional capacity, and also tend to encourage economy of use, thus reducing additional capacity requirements. Where appropriate, state subsidization, or "circuit breakers," could be implemented to reduce hardship for low-income users. (See next strategy section.)

Market Debt More Effectively. Markets for municipal debt operate in predictable ways. For example, the more information provided about communities and their financial situation, the lower borrowing costs tend to be. In addition, interest rates for debt issues can be kept down by keeping municipal paper issues below state and regional monthly quotas established by institutional investors.

Encourage Competitive Underwriting. Attracting more bidders drives down both underwriting costs (reducing costs by about \$15 per \$1,000 of face value) and net interest costs (by about 30 basis points or .3 percent). Montana would encourage greater underwriting competition for revenue bonds by broadening the powers of commercial banks to participate in underwriting, as Arizona has done recently. This broadened distribution of powers, combined with the knowledge commercial banks have of local economies, places them in an ideal position to assess the collateral underlying bond issues.

Infrastructure Tactic #3: Create a Water Rights Procedure That Facilitates the Transfer of Water Rights Among All Beneficial Users

All states, particularly those in the arid West, are recognizing water as a critically valuable economic resource, and are developing policies to ensure that scarce surface and ground water resources are used for the greatest benefit of their citizens.

Despite the recent drought and water supply problems in the state, Montana has more water to meet future needs, and more flexibility in meeting those needs, than most of its neighbors. Montana's municipalities use only 1.4 percent of the state's water, for example, compared to an average of 7.4 percent for all the western states.⁴⁰ Even with generous estimates of future urban-area growth in Montana and assuming the development of no further supplies, less than one percent of the water would have to be diverted from irrigation to meet additional demands by the year 2000.

Still, local problems exist and groundwater overdrafts already are occurring. Montana probably will be able to meet demands and protect the environment, provided that water laws allow for the transfer of water from low-value to high-value uses. To meet all demands within a locality, however, the options appear to be to utilize other water sources (deep aquifers, for example) or provide more water storage, thereby increasing water supply, or to encourage improved water use efficiency, thereby decreasing water demand. Montana water law needs to protect all those affected, directly or indirectly,

by water transfers. An accurate adjudication of existing water rights to ensure that water rights are not inflated also is crucial to making a determination that others are not adversely affected. Actually, the state already has recognized this need. In 1985, the Legislature analyzed the need for water marketing and established a permanent Water Policy Committee. The complex task of adjudicating water rights has begun in the Water Court. In addition to these steps, the state needs to clearly define water rights in terms of consumptive use, help local authorities develop procedures to market water, and integrate public trust values (recreational, environmental, etc.) into water markets.

STRATEGY IV: STRENGTHEN LOCAL GOVERNMENTS' FISCAL CAPACITY

Whatever broad policy guidance comes from the state, economic development happens locally. Local governments need to be able to plan effectively and raise the money they need to invest in business support systems. But because local governments in Montana generally are small and have limited fiscal powers and technical expertise, they often cannot meet the demands, or offer many of the less tangible prerequisites to development--marketing, developing public/private partnerships, and many other activities--that create an entrepreneurial climate.

Montana shares governance among 1,179 units of local government--including 56 counties, 127 municipalities, 546 school districts, and 450 special districts. The state is responsible for raising only 53 percent of state and local revenues, ranking it 39th in the nation. Local governments in Montana, in turn, rely more heavily on property taxes than in most states. There are alternative sources of income available in limited circumstances (county excise taxes for road construction and repair; taxes on goods and services in certain resort communities) but only four communities have employed these options to date. State grants to local government have plummeted as severance tax revenues have declined. Over time, therefore, the state must recognize the growing responsibilities and capabilities of local governments and expand their revenue-raising options.

A number of current management practices adversely impact local governments' efficiency and ability to compete. Many of Montana's school districts, for example, still use the single entry cash basis for accounting, which fails to meet national accounting standards and is unable to produce timely and valuable revenue/expenditure information. Many counties that receive funds from the Department of Highways have no systematic transportation planning or management capacity. And, while the local Government Assistance Division of the Department of Commerce has standardized accounting procedures for cities and counties, it has no jurisdiction over school districts and special purpose districts. The Office of Public Instruction, however, which oversees school districts, provides financial technical assistance, but is able to provide little in planning and accounting technical assistance. As a consequence of these limitations, local governments often are unable to secure preferential bond interest rates or obtain unqualified opinions on audits.

To strengthen local fiscal capacity, two tactics can be pursued: (1) create a Local Government Finance Corporation, (2) employ user fees tempered

by low-income household circuit breakers.

Local Capacity Tactic #1: Create a Statewide "Local Government Finance Corporation"

The Governor's Task Force on Infrastructure (1984) concluded that the state should provide local governments with training on capital facilities planning and help cover the costs of that planning.\41 The state has created a bond pooling mechanism, operated by the Board of Investments, but because it does nothing to improve the local collateral backing the bonds, it is, in effect, a way for low-risk communities to subsidize the rates for higher risk communities. Most investors are smart enough to "pierce the veil," and the stronger communities soon will find it cheaper to go to the market directly.

There is an alternative. North Carolina's Local Government Commission provides a successful model for technical assistance. Created in the 1930s following the bankruptcy of several communities in the state, the commission helps local governments select rating agencies, issues financial reports, trains local officials, conducts independent audits, and maintains and publishes an extensive data base on the financial and economic condition of local governments. More important, it reviews, approves, and markets local bonds. It charges communities a fee for its services and thus is accountable directly to the communities it serves. It does not regulate; it survives by being competent. The commission has successfully reduced the risk of local issues, cutting interest costs .35 to 1.00 percentage point.

A similar Montana "Local Government Finance Corporation" could be built from the strengths of the Local Government Assistance Division of the Department of Commerce and could use the extensive project, construction, maintenance, and cash flow management systems developed by the Department of Highways. The corporation would require initial funding, but could be self-financing within five years.

Local Capacity Tactic #2: Employ User Fees Tempered with Low-Income Household "Circuit Breakers"

The principal objection to user fees for publicly provided infrastructure services is that they will prove a hardship for low-income households. While the state cannot and need not fund infrastructure where beneficiaries are clearly identifiable, it can, however, pay a portion of a project's cost that exceeds a predetermined fraction of poor households' incomes. This mechanism--in the form of a property tax credit to households, or "circuit breaker"--already exists in more than 20 states and could be implemented in Montana to cover the costs of large capital projects. The state also could employ this same mechanism to protect low income families as it broadens the use of user fees to pay for other local services.

STRATEGY V: STRENGTHEN STATE FISCAL CAPACITY

Many Montanans believe that taxes are the biggest barrier to economic development in the state. But despite the hot and nearly continuous battle over taxation in the state, Montana's taxes are at or below national averages.

Personal income taxes, for example, are low and moderately progressive. A family earning \$35,000 and living in the state's largest city would pay 6.3 percent of its income in state and local taxes--ranking Montana 41st nationwide and lower than any neighboring state except Wyoming.\42 By comparison, a Montana family earning \$20,000 would pay 6.2 percent (44th nationally) and a family earning \$75,000 would pay 7.0 percent (41st nationally).

Corporate income taxes are about average for the nation. The marginal tax rate on corporate income is 6.75 percent, 24th lowest in the nation. Personal and corporate income tax combined accounted for 20 percent of Montana's revenue, compared to 25 percent for the nation as a whole.

Property taxes appear high on a per person basis in Montana, but in fact are not. About one-third of all property taxes is paid by coal, oil, and gas companies. Property taxes paid by Montana residents and other businesses are actually relatively low. The average property tax on a single family home in Montana, for example, is 1.28 percent, ranking Montana 18th in the nation.

Sales and gross receipts taxes represent only 12 percent of state revenues, compared to 36 percent nationwide, again placing Montana well below average. Montana's severance taxes account for another 12 percent of revenues.

Montana need not feel obliged to cut taxes in order to "compete" with other states. It is already competitive. Ultimately, the competition for economic development will be won by states that have invested their tax revenues wisely and consistently in the basic economic building blocks--education, welfare reform, infrastructure, and business technical assistance, for example. The state's tax policy needs to be guided by the principles of fairness, stability, and efficiency--not by the demands of individuals for preferential treatment.

Still, tax issues will continue to arise, and the state must strive to ensure that no aspect of its tax code places Montana far out of line with other states.

In general, the state needs to pursue two basic approaches: (1) reduce preferential state and local tax abatements and exemptions, and (2) develop a long-term tax strategy that aims to be more neutral and more equitable.

State Fiscal Tactic #1: Reduce Preferential State and Local Government Property Tax Abatements and Exemptions

Like most states, Montana sometimes has promoted economic development through special tax inducements. Unfortunately, one person's tax reduction is either another person's tax increase or the loss of a public service. In an effort to attract new businesses, communities bid against each other on the basis of low taxes. In the end, this action has virtually no effect on locational decisions made by the businesses, and forces existing local businesses to subsidize newcomers.

Good tax policy is not the same as low tax policy. Good tax policy is the effective and efficient "balancing of the government services offered to businesses and residents against the taxes that they pay."43

State Fiscal Tactic #2: Develop a Long-Term Tax Strategy That Contains Overall Tax Rates and Makes the Tax System More Neutral and More Equitable

As state government adjusts to a decline in coal severance tax revenue, pressure to increase or change the structure of the tax system can be expected. Recognizing the need for a comprehensive review of Montana's tax system, the Governor introduced a tax reform proposal in the 1987 Legislature. Extensive revision, however, was postponed in favor of ad hoc problem solving. The use of volatile tax sources to finance constant services in the long run, though, will be seen as poor fiscal practice by the investment banking community and reform will be necessary at some point.

Asking whether taxes are "too high" separates the consideration of taxes from the consideration of the services they make possible. Taxes are the price one pays for services received that cannot be covered by user fees, and the two must be considered in tandem. All people would be willing to sacrifice some services for lower taxes, although there would be disagreement over which services to reduce. And all would be willing to pay more taxes to improve some services, although, again, people would disagree about which ones to improve. The important questions remain: "Are the right kind of public services being provided and being done so efficiently?" and, "Are the right taxes paying for those services?"

When evaluating tax policy, the following questions need to be asked:

1. Are they neutral--creating as little disruption in economic activity as possible and as little distortion in favor of one type of activity or taxpayer as possible?

1. Are they vertically equitable--increasing as the taxpayer's ability to pay increases?

3. Are they horizontally equitable--taxing households and businesses with similar resources in similar ways?

4. Do they promote fiscal stability--yielding revenues that will rise and fall the same way the services they pay for do?

5. Are they cost effective--with the cost of collection low relative to the revenue they generate?

THE STATE AS INNOVATOR

The economic development strategies outlined in this document--investing in the workforce, in entrepreneurship and business innovation, in infrastructure, and in the capacity of local and state government--address what might be done differently to establish stronger building blocks for Montana's emerging economy. They deliberately avoid industry-by-industry actions in favor of creating an economic environment in which all industries can grow.

The strategies and tactics presented here for discussion follow a few common themes that, taken together, describe the role of state government in the business of economic development:

- o They envision a limited but active role on the part of the state, a role that is market perfecting, not market replacing;
- o They are fiscally conservative, recognizing the limitations of state budgets and leaving to private financial markets the principal business development and investment decisions, involving the state only to fill gaps in those markets and fulfill accepted public responsibilities;
- o They require that state and local governments analyze carefully the costs and returns on investments, much as any responsible business manager would; and
- o They build partnerships, recognizing that we all have a stake in Montana's future.

This is state government as innovator--taking calculated risks in order to achieve clearly articulated objectives as it advances economic development...and a better life for all Montanans...today and into the next century.

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